

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
ACTIVE INTERNATIONAL FIXED INCOME – EXTERNALLY MANAGED**

~~September 16, 2005~~October 17, 2005

This Policy is effective immediately upon adoption and supersedes all previous externally managed active international fixed income policies.

I. PURPOSE

This document sets forth the investment policy (“the Policy”) for the Externally Managed Active International Fixed Income Program (“the Program”). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees’ Retirement System (“the System”) take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of global capital markets.

II. STRATEGIC OBJECTIVE

Gaining exposure to non-U.S. dollar fixed income [securities](#) is the strategic objective of the Program.

The Program shall be managed to accomplish the following:

- A. Diversify the System’s overall Investment Program;
- B. Enhance, during a specific period, the total return of the System’s Fixed Income Program;
- C. Dampen the overall risk of the System’s Investment Program; and
- D. Consider solely the interests of the System’s participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

- A. The **System’s Investment Committee** (“the Investment Committee”) is responsible for approving and amending the Policy.

The Investment Committee delegated the responsibility for administering the Active International Fixed Income portion of the System to the Investment Staff through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).

B. The **System's Investment Staff's** ("the Staff") duties include, but are not limited to, the following:

1. Developing and recommending the Policy to the Investment Committee.
2. Developing and maintaining a procedures manual, subject to periodic review and updating, outlining Staff operational procedures used in implementing this Policy.
3. Implementing and adhering to the Policy.
4. Recommending action concerning outside money management firm(s) ("Managers") retained under contract to implement the Program. The Staff shall make recommendations in accordance with the [Currency Overlay](#) and Manager Monitoring - Externally Managed Policy, regarding changes in the Manager's contractual guidelines, and any other aspect Staff considers pertinent.
5. Reporting to the Investment Committee, as needed, about the performance of the Program and monitoring implementation of, and compliance with, the Policy. The Staff shall report concerns, problems, material changes, and all violations of Guidelines and Policies immediately and in writing to the Investment Committee including explanations of the violations and appropriate recommendations for corrective action.

C. **Managers** are responsible for all aspects of portfolio management, as set forth in each Manager's contract with the System, and shall include the following duties:

1. Communicate with the Staff, as needed, regarding investment strategy and results. The Investment Committee and Staff expect the Managers to monitor, analyze, and evaluate performance relative to the agreed upon benchmark.

2. Cooperate fully with the System's Staff, [Custodian](#), and [General Pension Consultant](#) concerning requests for information.

D. The **General Pension Consultant** is responsible for monitoring and evaluating the Manager's performance relative to the benchmark and Policy. The General Pension shall report to the Investment Committee on a quarterly basis in accordance with its contract.

IV. PERFORMANCE OBJECTIVE

The Program is expected to outperform the benchmark by at least 1.5% annualized throughout a normal market cycle of three-to-five years, net of fees.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Approach

1. The international fixed income portfolio shall be managed to maximize return and minimize risk through the selection and allocation of permissible [bond](#) markets. Within those markets, manage the selection and allocation of maturities, durations, credits, currencies, and approved [derivative](#) instruments. Consider macro and relevant micro-economic factors including, but not limited to, economic growth, inflation, [monetary](#) and fiscal policy of eligible countries, the credit risk of market and [issuer](#), and risk-adjusted yields. ~~This program shall be invested in investment grade securities (securities rated no lower than Baa by Moody's Investor Service, or BBB by Standard & Poor's) or their equivalent.~~

2. Holdings of emerging market debt are subject to a limit of the aggregate benchmark emerging market exposure plus 5 percent on a manager's combined holdings, as well as a single country concentration limit equal to a country's benchmark exposure plus 5 percent.

- 2.3. The Program shall be implemented through the retention of an [external manager\(s\)](#). External manager selection shall occur in accordance with Section V. B. of this Policy.

3.4. The viability of the Program shall be reviewed annually, with a formal review occurring at least every five years.

B. External Manager Selection

1. The System shall retain manager(s) with recognized expertise in the analysis and selection of non-dollar fixed income securities, credit analysis, and currency or approved derivatives. The selected manager(s) shall be registered with the Securities and Exchange.
2. The manager(s) shall be selected in accordance with the Contract and Procurement Policy.

C. Investment Parameters

Each Manager shall operate under a set of specific guidelines that outlines its investment philosophy and approach, representative portfolio characteristics, permissible and restricted securities and procedures, and strategic and performance objectives

Implementation of this Program shall comply at all times with the applicable investment policies including, but not limited to, the following:

1. ~~Permissible Country Debt Policy;~~

2.1. Foreign Exchange Guidelines;

3.2. Investment Derivatives for External Money Managers;

4.3. Currency Overlay and Manager Monitoring— Externally Managed Policy; and

5.4. Manager-specific Investment Management Guidelines.

D. Specific Risk Parameters.

1. For local-currency debt of national governments and all debt of corporations and subnational governments (i.e. provincial, state, and municipal) and corporations; this program requires a minimum investment grade rating (securities rated at least Baa3 by Moody's Investor Service (Moody's), or BBB- by Standard & Poor's (S&P) or Fitch Ratings (Fitch).

2. For global debt which is issued in major, developed markets by national governments requires a minimum rating of Ba3 by Moody's or BB- by S&P or Fitch.
3. The country must be part of the Lehman Global Aggregate Index.
4. The country's currency must be fully convertible in the spot market for foreign investors.

VI. BENCHMARK

The benchmark for this Program is the Lehman Brothers International Fixed Income Index. ~~Salomon Smith Barney Non-U.S. World Government Bond Index.~~

VII. GENERAL

Investors, managers, consultants, or other participants selected by CalPERS shall make all calculations and computations on a market value basis as recorded by the System's Custodian.

VIII. GLOSSARY OF TERMS

Definitions for key words used in this policy are located in the Fixed Income Glossary of Terms which is included in the System's Master Glossary of Terms.

Approved by the Policy Subcommittee: August 11, 1999
Adopted by the Investment Committee: October 18, 1999
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Asset Class Glossary: Fixed Income
Policy: **Active International Fixed Income - Externally Managed**
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Bond

A unit of debt, \$1,000 of principal or par amount. For 200 years municipal bonds were sold in \$1,000 denominations. Since the mid-1970s the minimum bond denomination has been \$5,000; nevertheless, "A Bond" is bought, sold, referred to, and priced as if it were \$1,000.

Currency

The monetary unit of a sovereign state.

Custodian

A bank or other financial institution that provides custody of stock certificates and other assets of an institutional investor.

Derivative

An instrument whose value is based on the performance of an underlying financial asset, index, or other investment. Classes of derivatives include futures contracts, options, currency forward contracts, swaps, and options on futures.

Emerging Market

Countries not classified as having developed bond markets by internationally recognized index providers.

External Manager

An outside money management firm retained under contract by CalPERS.

Fitch Ratings

A nationally-recognized credit rating agency that grades the investment quality of bonds. The ranges extend from the highest investment quality, which is AAA, to the lowest credit rating, which is D. Securities rated BBB- or greater are considered investment grade. Securities rated BB+ or below are considered speculative.

General Pension Fund Consultant

An individual or organization that provides specialized professional assistance to the CalPERS Board of Administration in determining the pension fund's asset allocation model or optimal combination of investments in order to maximize risk-adjusted investment returns in a manner consistent with the State's long-term pension liabilities.

Global Debt

Debt issued by a national government, subnational entity or corporation denominated in the U.S. dollar or other major currency and issued in major markets, typically New York or London, under the laws of those markets.

Investment Grade

A ~~minimum~~ credit rating of at least Baa3 by Moody's Investor Service or BBB- ~~for~~by Standard & Poor's Corporation, ~~and~~ or BBB- by Fitch. Investment grade ratings apply to issuers whose financial risk is relatively low and the probability of future payment relatively high.

Issuer

A state or local unit of government that borrows money through the sale of bonds and/or notes.

Local Currency Debt

Debt issued by a national government, subnational government or corporation denominated in local currency and issued in the local market, under local laws.

Monetary Policy

Refers to the management of the money supply to affect the macro economy through movements in the level of short-term interest rates, such as the Fed Funds and the Discount Rate, or supplying more credit to the banking system through open market operations.

Moody's Investors Service

A nationally-recognized credit rating agency that grades the investment quality of bonds ~~in a 9-symbol system~~. The ranges extend from the highest investment quality, which is Aaa, to the lowest credit rating, which is C. Securities rated Baa3 or greater are considered investment grade. Securities rated Ba1 or below are considered to be speculative.

~~Permissible Country Debt Policy~~

~~The System's guidelines for permissible country debt investments, as most recently amended.~~

~~Salomon Smith Barney Non-U.S. World Government Bond Index~~**Lehman Brother International Fixed Income Index**

The index covers the available market for foreign currency-denominated government bonds. It contains an all-inclusive universe of institutionally traded bonds. It includes all fixed rate bonds with a remaining maturity of one year or longer with amounts of at least the equivalent of U.S. \$250 million outstanding. The index excludes floating or variable-rate bonds, and private placement-type securities. The Index provides an accurate, replicable fixed income benchmark for market performance. It measures the total return performance of the foreign currency-denominated government bond market. The index captures returns in U.S. dollars.

Security

Instrument that signifies an ownership position in a corporation (stock), a creditor relationship with a corporation or governmental body (bond), or rights to ownership such as those represented by an option, subscription right, and subscription warrant.

Standard & Poor's

A nationally-recognized credit rating agency that grades the investment quality of bonds in a 10-symbol system. The ranges extend from the highest investment quality, which is AAA, to the lowest credit rating, which is D. Securities rated BBB- or greater are considered investment grade. Securities rated BB+ or below are considered speculative.